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I feel no doubt or hesitation whatever as to the causes of the world slump. I trace it wholly to the breakdown of investment throughout the world. The problem of recovery is, therefore, a problem of re-establishing the volume of investment.

***"The Originating Causes of World-Unemployment,"* J.M. Keynes**
Collected Writings of John Maynard Keynes, Vol. XII, London 1972

Deflation or Reflation?

Alan Greenspan's rescue of the U.S. bull market this past fall has worked wonders. Not only did it procure the celebration of the Dow at 10,000, it propelled a doubling for prices of Wall Street firm's stocks, a doubling of the technology and telecommunications indices, a 90% rise in NASDAQ and a trebling of Internet shares. Almost $3.5 billion of market capitalization has been added to the already-dear American stock values since the October 1988 lows. Mr. Greenspan's triumph has almost destroyed any remaining shreds of doubt the bulls may have had in their wild optimism.

The all-too-successful American reliquification has had a profound impact on economic analysis as well as investors' perceptions of risk. Indeed, nothing breeds success like success, and with this in mind, many investors gleefully perceive that Mr. Greenspan and Mr. Rubin have solutions for virtually any ill, anywhere. Not even the most onerous global crisis since the Great Depression intimidates the bullish contingency. Instead, the talk in America is of the "island of prosperity" it represents in a "troubled global ocean." The comforting watchword is reflation; the cure-all is printing money.

The American view holds that monetary policy is omnipotent. It flatly denies that structural dislocations may blunt policy instruments. If economies elsewhere have not yet responded to monetary stimulus, it is only because policy has not been aggressive enough. If fiscal policy has thus far proved impotent, it is only because it has not been applied in conjunction with appropriately forceful monetary pump priming.

The resounding prominence of this view is reinforced by the striking divergence between stellar financial markets and dismal economic performances around the globe. Despite a currency collapse and plunging production, share prices in Brazil have more than doubled since January's currency debacle. In Mexico, share prices have soared 45% since January lows. Ignoring the surprising rapidity of economic slowdown, European bourses have risen 25% to 50% since October. In Japan, the Nikkei has a year-to-date gain approaching 20% while the gain for the JASDAQ index of Japanese OTC stocks is nearly 30% higher.

Rarely in history has perception swung so widely from reality. And rarely, if ever, has investor euphoria so adulterated economic analysis. Nonetheless, the reality of the situation remains that the root causes of this global economic crisis are of a deep-seated structural nature, against which looser money and bigger budget deficits are destined to prove woefully ineffective. Today's problems stem from years of reckless global credit excesses, the most obvious legacy of which is global excess capacity

In sorting out this most extraordinary economic environment, history has a great deal to teach us. In this letter, we dig deep into the 1920's credit-induced U.S. boom and its horrid aftermath. It is in that era that we can pinpoint the origins of the momentous fallacy that now hinders American economic analysis.

WHAT IS DEFLATION?

Deflation is a loaded word, especially in the United States. It conjures up images of the Great Depression with mass unemployment and collapsing production. On the other hand, there is a tremendous confusion about its essence and implications, worse even than in the prevailing muddle of thinking about inflation. American

economists, traditionally, limit the meaning of both words to changes in the price level. For them, in short, the movements in the indexes of consumer and producer prices are the crucial test of inflation or deflation. Nothing but the price indexes matters. A persistent rise in them implies inflation and a persistent decline, deflation.

As we have repeatedly pointed out, this narrow interpretation of inflation has long been a bone of contention between American and European economists. For the Europeans, the causes potentially affecting the price levels are too many and too complicated to use the price indexes as a reliable gauge of monetary inflation. Actually, the compelling evidence is taking place before our eyes. High-tech prices in the United States have plummeted by more than 80% since 1982. Judging by their price index, this sector of manufacturing is in the grips of savage deflation. In reality, it has been booming on the back of even steeper productivity growth. Resulting record-high profits led to record-high capital expenditures. Rather than experiencing deflation, the high-tech sector has been in a profit and investment inflation.

INFLATION CONUNDRUM

In a way, this high-tech experience of today is reminiscent of the Roaring Twenties. Then, too, America's inflation did not show in the price indexes. The consumer price index in 1929 was at virtually the same level as in 1923, while wholesale prices fell at the rate of 1% per year. With reference to these price movements and an average annual rise of the money stock of 4%, Milton Friedman calls this period in his *Monetary History of the United States* a time of "relative deflation." In the same vein, he explicitly disputes the then widely-held view that the 1920s were a period of inflation and that the collapse from 1929 to 1933 was the inevitable consequence of what had gone before.

The main advocates of the inflation view were the leading figures of the Austrian School of economics (Mises, Hayek, etc.). Primarily, they harped on a rampant credit expansion as the crucial and infallible earmark of an inflationary boom. In 1929, the debt-to-GDP ratio was 2.04. For each dollar added to GDP there were two dollars additional debt.

In the 1920s, the Austrians discarded the stability of the price indexes as deceptive with the argument that the effects of an enduring rampant monetary expansion on the price lever could be offset by very high productivity gains. Rapid progress of technology and organization stimulated heavy investment in new production techniques. The most important stimulus to investment and the expansion of output in the 1920s had come from the automobile. Productivity per man-hour in manufacturing rose some 70% between 1919 and 1929, warranting, in reality, declining prices. As a result, stable and falling prices went together with sagging labor unit costs and rising profit margins. Unemployment averaged 3.3%.

At the time, actually, most American and British economists had applauded the Federal Reserve for having prevented a general decline of prices. Nobody thought of possible inflation. Professor Irving Fisher, the leading economist of the 1920s, became famous as head of the "stable money" movement in the United States. Stability of the price level was regarded as a safeguard against depression. In Germany, the popular cry for "stable money" is traditionally directed against rising prices, but in America of the 1920s it was directed against a falling price level. In both countries, this thinking was shaped by the respective country's specific experience in 1921-23. The United States experienced a sharp recession with plunging prices in that period, while Germany had a runaway inflation that completely destroyed its currency.

On the face of it, the U.S. economy looked exceedingly healthy and strong in the 1920s. Against the background of a stable price level, GDP growth averaged close to 4% per annum from 1923 to 1929. Wall Street hailed the arrival of a "new era" that perfectly justified the steep increase of stock prices that was taking place. In fact, they quadrupled.

Now, how do present U.S. economic conditions compare with those in the 1920? In brief, unfavorably, if

not miserably: First of all, capital formation and productivity growth are considerably lower today. However, the most striking and most instructive difference between the two periods is in the balance of payments. With a personal savings ratio of 10% the U.S. economy in the 1920s experienced a booming domestic demand and a chronic trade and current account surplus, essentially reflecting an excess of domestic savings over domestic investments. The United States was the dominant creditor country of the world, exporting capital out of genuine savings, rather than from fiat money creation. Today, the diametric opposite applies. With the lowest savings ratio in the world, the United States is the world's greatest debtor country, running a huge chronic trade and current account deficit.

THE CREDIT EXCESSES OF 1927-29

What went wrong in the 1920s? Very few observers recognized the mischief done to the economy and the financial system by exorbitant credit excesses in the final mad years of 1927-29. The main source of money and credit creation was the securities markets. During these three fateful years, more than $30 billion-worth of new issues came to market, of which $7.6 billion corporate stocks and $10.4 billion corporate bonds. On top of these bank and broker loans contributed $6-7 billion. To put these figures into perspective, this amounted to about four times the simultaneous GDP growth, which only increased during these years from $90 billion to 98 billion.

The crucial point is that corporations floated new securities vastly in excess of their immediate economic needs. Joseph Schumpeter noted that the American corporations "entered the great depression with a financial outfit which was nothing short of luxurious." The trouble was that, in their desire to profit on their rising cash surplus, corporations embarked on massive financial speculation, building up a highly leveraged financial superstructure of holding companies, investment trusts, and other forms of intercorporate security holdings that were to come crashing down in the 1930s. Investment bankers were hyperactive in the promotion of companies to hold the securities of other companies.

Being unable to compete with the favorable conditions of the securities markets, the commercial banks virtually dropped out as direct lenders to business. Yet they heavily participated in the developing financial boom by their own heavy purchases of securities, by rapidly expanding loans on securities; and by loose lending on real estate. Rather than making direct loans to businesses, bank lending and corresponding massive money creation took its way indirectly through the securities markets. No less than 86% of bank credit growth went into purchases of securities for their own account or into financing their customers' speculations.

As this rampant investment-credit expansion of the banks forced the long-term interest rate downward, corporations found it increasingly profitable to float bonds and issue stocks, using the proceeds to retire their bank loans or to lend the money out at high rates to the stock exchange call-loan market, adding further fuel to the stock market speculation. In an aggressive search for new credit business, the banks also turned to export credit and consumer credit. All this contributed to the deceptive prosperity of 1928-29, the intrinsic weakness and spurious character of which were not recognized until the *credit* bubble burst in 1931.

The earlier bursting of the stock market bubble in October 1929 had already exposed the weakness of the financial structure and initiated a protracted deflation in capital investment. Yet, even after the stock market crash, any foreboding of the coming disaster was completely absent. On the contrary, economists argued that the period of easy money ushered in by the stock market crash would promote business. The high-riding economic expectations built up during the long preceding boom were not immediately shattered by the stock-market crash. They began to dim only a year later, when the banking system showed its first cracks.

DISPUTED CAUSES

Among the industrial countries, the United States was to suffer by far the steepest and longest slump

between 1929-33, with declines in GDP and national income by more than 50%. After a sharp inventory-driven recovery in 1936-37, the economy collapsed again to a level below that of 1929.

We have reviewed this boom–bust sequence of the 1920-30s in America because—with the present situation in mind—we want to emphasize one thing, and that is the all-important role of credit excesses as the harbinger of the Great Depression. Credit—not money—represents the key source of increases in the purchasing power for the acquisition of goods, services and assets. This focus on credit expansion, rather than money growth, is particularly important in the case of the United States, where the greater part of credit creation is currently taking place outside the banking system and therefore, not creating money. Only bank lending creates money. That's why the worst credit excesses do not fully show in the money supply figures. Non-bank credit increases money velocity instead, implying a more intensive use of the existing money supply.

Completely ignoring the credit excesses and focusing narrowly on money growth, Milton Friedman and the monetarists have never seen anything wrong in the financial system of the 1920s. In his *Monetary History of the United States*, Friedman states in his concluding remarks that "the stock of money rose at the annual rate of 4% per year, which is roughly the rate required to match expansion of output." Given such modest money growth and a gradual decline in wholesale prices, he rather perceived the 1920s "as a time of relative deflation."

What, then, was the main cause of the protracted U.S. depression? Was it the inevitable aftermath of the prior bubble excesses, against which the Fed's drastic monetary easing was powerless? That was the prevailing view in the United States until the early 1960s, when Milton Friedman and Anna Schwartz overturned it with the publication of their *Monetary History of the United States*. Being completely oblivious of the credit excesses of the 1920s, Mr. Friedman drew the conclusion that "the monetary collapse from 1929 to 1933 was not the inevitable consequence of what had gone before. It was the result of the policies followed during those years.... Alternative policies that could have halted the monetary debacle were available throughout those years. Though the Federal Reserve proclaimed that it was following an easy-money policy, in fact, it followed an exceedingly tight policy."

Meanwhile, this verdict has become the more or less unquestioned, conventional view among American economists. What's more, it implies that a central bank has it in its power at all times to generate necessary and desired money growth—and consequently to prevent any recession.

PUSHING ON A STRING

A controversial debate persists over the power of monetary policy. One side claims the Fed's actions in the 1920s were inadequate to stimulate the economy. The other says actual monetary policy was loose but failed to take effect because it was thwarted by adverse conditions in the banking system or the economy. In the monetarist view, the economic collapse of the U.S. economy in 1929-33 had one single cause: a collapse of the money stock, for which the Fed's inept policy was responsible. As Milton Friedman has put it: "Deflation is the easiest thing in the world to avoid; you just print money." Friedman and the montetarists conveniently overlook the fact that the money stock did not decline significantly until March 1931, after the economy had already plunged into deep depression. What the country had been struggling with appeared to be, not a shortage of money, but plunging capital values in financial and real assets and a general loss of confidence in banks and business prospects.

As a matter of fact, the Fed did in act pretty fast. The New York discount rate was reduced twice in November 1929. Four more cuts in 0.5% steps brought the rate in June 1930 to 2.5% compared with 6% in August 1929. It was to fall to 1.5% in May 1931. Even more important, the Federal Reserve continued to buy securities in the open market to foster a credit expansion by injecting excess reserves into the market. From the spring of 1933, bank reserves, partly deriving from gold inflows, continuously exceeded requirements by a

substantial amount. By the fall of 1935, excess reserves reached a total of $3 billion. If fully utilized, the banks could have more than doubled their total loans and investments, amounting at the time to $29 billion.

By historical standards, this was a prompt and drastic monetary easing. But the monetary action was completely ineffective this time. The jaded economic organism refused to respond, even though the government (Roosevelt) lent support with heavy deficit spending, running at around 5% of GDP. At the time, frustration with the ineffectiveness of the unprecedented experience elicited the adage of "pushing on a string" for the central bank's failure to move the economy in the desired direction.

What, then, did foil the U.S. recovery in the 1930? Unintended monetary tightness, according to Mr. Friedman. Before his gospel pervaded public opinion, it had been the prevailing view that the monetary easing was frustrated by the excesses and imbalances from the bubble period which the private sector had to work off. The most outstanding departure from past experience was the collapse in investment spending, including residential building. While cyclical recoveries in the past had always been investment-led, the recovery efforts of 1933-37 were led by consumer spending, fueled by the government's deficit spending. It was generally implied that higher consumer spending was the surest way to stimulate investment spending. But investment spending refused to follow this prescription. For the United States, the Great Depression never ended. It was swept away by World War II.

1990: REPLAY IN JAPAN

The present vigorous, but futile, attempts of the Japanese authorities to reactivate their economy with rock-bottom interest rates and massive deficit spending vividly reminds us of the frustrating American experience in the 1930s. Even though Japanese fiscal and monetary measures have even been far more aggressive, the effects are just as disappointing. Typically, American economists have no other explanation for deflation than that monetary policy is too tight.

In Japan, just as in the United States in the 1930s, interest rate cuts and deficit spending seemed to work at first. In 1996, Japan's real GDP expanded 3.9%, the best outcome among the seven major OECD countries. But it was only a brief burst, mainly derived from forward buying due to an impending consumption tax hike and stock building.

The most striking and also most important similarity between Japan's experience now and the United States' in the '30s is the parallel in the behavior of fixed investment. The deepening recession in Japan today is clearly centered in steep falls in building and business investment. Even with a standard mortgage rate of barely 2%, residential building has suffered its sharpest rate of decline ever. According to the latest monthly report from the Bank of Japan, the leading indicators for fixed investment, such as machinery orders and nonresidential construction starts, continue to decline at a rapid pace. In February, machine tool orders were down 31% from the same month a year ago.

The crucial point to see is that investment spending, particularly building, has the greatest multiplier effect on income and output. For this reason, European economists have always regarded investment activity as the tail that wags the dog. As the Bank of Japan elucidates, this protracted downward adjustment in fixed investment has three main causes: first, increasing perceptions of excess capacity; second, plunging corporate profits, and third, constraints from corporate finance. What's worse, no relief is in sight for any of these negative factors.

SILLY ADVICE: PRINT MONEY

In our view, the new optimism in the markets about Japan has no more substance than the new belief that the Japanese economy has turned the corner because the authorities are at long last heeding the advice from the international financial community—or more correctly, from American economists—to flood their economy and

markets with liquidity, blended with substantial corporate and personal tax cuts. Using a favorite expression of American economists, the Bank of Japan is now supposed to "print money." Having read many reports from American economists on this subject, we wonder, how knowledgeable they really are in monetary matters.

In the first place, it seems to have escaped them that the Bank of Japan has already temporarily engaged in massive liquidity injections. It made huge loans to financial institutions and bought a great deal of commercial paper, nearly half the outstanding stock. The result was an explosion of the central bank's balance sheet from 58 trillion yen at the end of October 1997 to a peak of 91 trillion yen at the end of March 1998. Though this liquidity injection equaled more than 5% of GDP, it was absorbed in the markets with little trace in the money supply or asset prices, let alone in economic activity, because credit demand and credit supply in the economy remained dead in the water.

Too many economists apparently do not realize that the actual creators of money and credit in our economies are the commercial banks, not the central banks. Every loan by a bank to a customer increases the total sum of bank deposits which account for the greatest part of the money stock. Bank purchases of securities have the same effect.

But what is the role of central banks? Principally, they exert only an indirect influence on the creation of money and credit through two levers at their disposal. The one lever is their interest rates, and the other is their open market operations, that is their buying or selling of market paper, normally government bonds, with the aim to increase or decrease the cash reserves of the banks (which the monetarists label as "high-powered money").

Strictly speaking, these so-called bank reserves are deposits of the commercial banks at the central bank, and the crucial point is that these deposits don't command any interest. When the central banks want the commercial banks to expand their loans or investments, it floods them with excess reserves. Faced with mounting deposits at the central bank bearing no interest, the banks normally comply in the desired way, trying to get rid of these deposits by expanding their loans.

But please note the word "normally." There have occasionally been exceptions to normal times in economic history. Above all, low interest rates inexorably diminish the effectiveness of this instrument. The lower the available interest rates in the markets, the smaller the loss of income for the banks on such reserves, and consequently the less the pressure and the need for them to put them to earning use. That certainly is the present the situation in Japan. The low rates available in the markets leave the banks with no incentive to expand.

THE ESSENCE OF DEFLATION

There is still another reason we are wary of the recent cries of economists, in particular American economists, for ever-lower interest rates in Europe, too. While Japanese policymakers were stupid enough to listen, we hope and believe that the European central bankers will resist these siren songs. Interest rates have two sides. On the one hand, they are costs to the borrowers; on the other hand, they are a source of income for the savings public. A central bank must strive to strike a balance between the two constituencies.

Most American economists focus exclusively on interest as the cost of borrowing for investment and consumption. Still, there is sure to be a point where ever-lower interest lose their magic as a stimulant. If businesses don't invest at 3%, it is improbable that they will do so at 2%. Extremely low rates, being widely regarded as signs of distress, may rather deter investment. But such an interest rate policy is absolutely foolish in respect to consumers and savers. By slashing interest rates virtually to zero, the Bank of Japan has effectively extinguished incomes from savings. Since the Japanese are far more savers than borrowers, this has inflicted a heavy loss of consumer income with the net effect of reducing consumer spending. Not only that, deprived of any income from their savings, Japanese households are forced to save even more than before in order to meet the financial targets they have set themselves for their old age.

After all, Japan is now a clear case of serious deflation. Having stated this, we hasten to add that this judgment of ours is not derived from the price indexes. For us, the relevant gauge of underlying inflation and deflation is the flows of funds between the sectors of the economy. The most important characteristic of a developing deflation is a shrinkage in business capital expenditures to below business cash flow. This implies a net contraction in private demand. The normal pattern in a healthy and balanced economy is that the business sector borrows the savings surplus of the private households for investments in building and equipment.

In Japan, the business sector has traditionally posted a large financial deficit, owing to heavy investment spending. Because this was matched by the very high savings ratio of private households, the economy enjoyed strong growth, low inflation and in addition a high foreign trade surplus. But this well-balanced relationship has collapsed. In 1994, corporate financial flows went from deficit into a growing surplus, as investment spending has since been falling increasingly below corporate cash flow. Given the big savings surplus of private households, the private sector as a whole is now running a huge financial surplus of around 10% of GDP, implying a persistent, drastic demand contraction on its part. The essence of deflation is that savings persistently exceed investments with the effect of decreasing the flow of purchasing power.

To keep the economy growing, this demand gap has to be filled. In the past years, this occurred partly through the rising export surplus. But with most of the world economy now in the doldrums, this safety valve has ceased to work. Desperate to fill this gap, the government has been launching a barrage of fiscal stimulus—with minimal response of the economy. It is our opinion that public deficit spending exercised at such a gigantic scale and for such a long time as in Japan, becomes self-defeating over time. In the first place, it doesn't touch the underlying problems. And second, just like near-zero interest rates, deficit spending undermines confidence.

CREDIT—THE GREAT AMERICAN MAGIC

Vigorous American economic growth is the pump that has kept the world economy from collapsing. It essentially leads to the question why the U.S. economy is faring so well. U.S. success is variously attributed to the macroeconomic wisdom of Mr. Greenspan, to the superior virtues of corporate management which, under the whip of having to deliver ever- higher shareholder value, is doing everything better than the managers in other countries, and to the insatiable hunger of American consumers.

One outstanding feature of the booming U.S. economy is the stunning surge in the growth of wages and salaries with a cumulative increase over the last two years by 17%. This rapid rise of job-related income is widely regarded as the single most powerful determinant of the consumer spending binge, leaving the stock market gains as a source of purchasing power far behind in importance. Relax, in other words, there is no bubble but solid employment and income growth. If so, it happily suggests that the boom can continue indefinitely.

True, the purchasing power to buy current production at all times comes overwhelmingly from current income. The circular character of the income stream further implies that it feeds on itself. Though there are always some qualifications to this, they do not invalidate the main proposition, which is, that income in one period is the main determinant of income and spending in the following period. Okay, but this means at best that the overall income level next year will be no higher than that of this year. What has to be explained is what provides next year's income growth. It doesn't come out of the blue as a stroke of good fortune.

Bringing about a rise in income essentially requires higher spending on goods and services. But what makes for higher spending? It is the most important question, and yet it can be answered in two words: credit growth. To furnish the additional purchasing power for next year's rise in spending and income, credit must expand. The inexorable causal sequence is, first, higher borrowing; second, higher spending; third, higher income.

Comparing the buoyant U.S. economic growth with the lackluster development in the other industrial countries, it is easy to identify credit growth as the *deus ex machina* at work in the U.S. economy, which is

keeping it running on high-employment overdrive. It is not superior technology, and it is not superior corporate management. Even if the U.S. economy should have an edge in these things, there is a much more fundamental reason: a borrowing spree plus massive realizations of capital gains in the stock market, fueling an unprecedented spending spree. As to the massive realization of capital gains, we want to point out that the associated creation of purchasing power does not show in either the money supply nor in the credit figures, only in the recorded plunge of personal savings.

The propensity of Americans to borrow is absolutely unique in the world, as is the willingness of the U.S. financial system to provide the necessary loans. This has been true for a long time, but what has been happening in this respect in the last few years beats anything in the past, except the 1920s. Non-financial debt increased last year by $952 billion; GDP growth was only $400 billion. But total borrowing and lending in the credit markets, including borrowing by the financial institutions, amounted to $2,090 billion, in contrast to $1,446 billion in the year before—an increase by 45%.

A GLOBAL STRUCTURAL BREAK

Earlier, we explained that Japan is caught in a savage economic contraction, because businesses and consumers both keep spending far below their revenue and income, which leads to a contraction of private domestic demand. Actually, the same is true for many countries in the world, though at a more modest scale than in Japan. There has been a structural break in the world economy. In general, investment spending now heavily lags the supply of domestic savings, and obviously this shortfall is not cyclical. It is global and structural. The last time that such a prolonged worldwide investment slump happened was in the 1930s.

In a recent issue, devoted to deflation as the new danger to the world, the London-based *Economist* stated that underutilization of capacity was presently at its highest since the 1930s. Actually, the 1990s have witnessed a global investment boom of historic proportion, in particular in developing Asia. However, capacity utilization is declining even in the United States. And what was the primary driver of this boom? In short, the biggest global credit bubble that the world has ever seen. By the way, a bursting global credit bubble was exactly what ushered in the Great Depression of the 1930s.

The outstanding exception to global economic weakness, so far, is the United States. In addition to strong domestic growth it is flooding the rest of the world with excess domestic purchasing power. How is this possible? And more importantly, can this last? The great majority of American economists seems to be convinced that it is possible. Not only are they wrong, but this view is outright ridiculous.

Much has been written about the spending spree of the U.S. consumer, stoked by heavy borrowing and stock market capital gains. However, he has not been alone in spending vastly beyond his means. So are U.S. corporations. Even though their profits and cash flow have been flagging since the third quarter of 1997, investment expenditures have remained buoyant causing a record corporate "financing gap" (as the corporate deficit is termed in the Fed's flow of funds accounts).

SHAREHOLDER VALUE THROUGH CHEATING

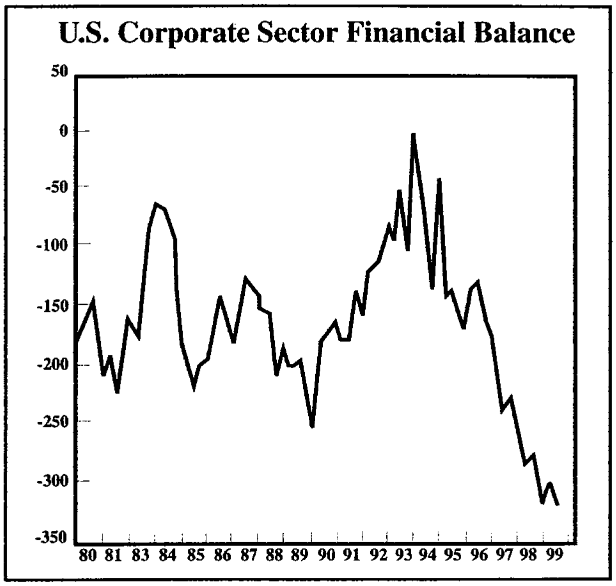
Corporate financial leveraging, reflected in rapidly accelerating debt accumulation, is trump. But the use to which the borrowed money has been put may be even more noteworthy. Net repurchases of common stock have virtually exploded over the last two years. In the fourth quarter of last year they hit a record amount at $474 on an annual basis. For the whole year, they actually amounted to $262.8 billion. This compares with $114 billion in 1997 and $50-60 billion in 1994-96.

At a time of shrinking profits and sky-high stock prices, corporate management is replacing cheap equity capital, yielding on average 1.4%, with much more expensive debt. Common sense suggests that this is crazy

from an economic point of view. Still it does make sense, but in a way that very much smacks of cheating shareholders about company profitability, not to speak of the effect of lifting share prices directly. Considering the widespread option schemes, executives have every personal motivation to drive the shares of their company higher in the short run. Their personal profit is today, not tomorrow, when the insanity of this policy comes to light.

CAN IT LAST?

The following chart illustrates the dramatic deterioration of the financial balance of the private sector during the 1990s. For America, too, it had always been the typical pattern that net borrowing by businesses was matched by a savings surplus of private households. Between 1960 and 1992, the two sectors together had, on average, a financial surplus equivalent to 1.1% of GDP. It never exceeded 1.2%, and such deficits never lasted for more than a year and a half. These fluctuations were clearly related to the ups and downs of the business cycle.



Since 1992, this has radically changed. The financial balance of the private sector has fallen in almost a straight line from a financial surplus of 5% of GDP in early 1992 to a financial deficit of 3% in 1998. Including the huge net repurchases of stocks, the deficit approaches 6% of GDP, essentially reflecting a corresponding surge in private borrowing. After all, this is the compelling evidence that the strong U.S. growth of the 1990s comes overwhelmingly from one source: the most rampant credit inflation.

We have read fantastic tales from American economists trying to explain why this mammoth financial imbalance on the part of the private sector is sustainable. What they fail to see is that for strong U.S. economic growth to continue, maintaining a high level of borrowing is not enough. It would require a permanent acceleration of this borrowing and lending binge, given that the budget is in surplus and foreign trade in deficit. This monstrous imbalance is unsustainable.

The only thing that could prevent the worst would be a strong recovery in the rest of the world, before the U.S. bubble bursts. Is the global economy on the mend? Sharply rallying stock markets seem to have been captivated by the idea that Japan and Europe will engineer more aggressive monetary easing and that economies in developing Asia are bottoming out. But so far, the world economy is not really improving. Japan remains mired in recession, and so does developing Asia, where booming exports have masked the weakness of domestic demand. In Latin America, contagion is spreading from sharply contracting Brazil to the rest of the continent. Euroland's economy is slowing. To be sure, the risks are rising, not falling.

THE LATEST CREDIT EXPLOSION

The U.S. economy alone continues to power ahead. In the wake of the Fed's easing, credit has been going through the roof. Total net borrowing and lending skyrocketed in the fourth quarter at an annual rate of $2.55 trillion, up from $1.89 trillion in the third quarter, and $1.45 trillion in 1997. For the bulls, this successful reflation of the credit and stock market bubble is comforting proof of their ability to sustain the financial and expansion.

U.S. private and public debt, combining non-financial and financial sectors, now stands at $22.7 trillion, or 260% of GDP. Total debt grew by $4.7 trillion over the past three years, an increase of 26%. In comparison, GDP expanded by $1.2 trillion, or 17%, to $8.5 trillion over this same period. Adding the current stock

capitalization of about $14 trillion to total debt, financial security claims on the U.S. economy today total more than $36 trillion, or 420% of total economic output as measured by GDP.

In 1998, for the first time, the financial sector actually had greater net borrowings—$1.116 billion—than the non-financial sector ($952 billion). For perspective, looking back 10 years to the boom year 1988, net non-financial sector borrowings were $786 billion, compared to $249 billion for the financial sector. Even as recently as 1993, financial sector debt growth was but half that of the non-financial sector debt growth. Since then, the financial sector has become king. For 1998, financial sector net borrowings exceeded 1997 borrowings by an astounding 71%, while additional borrowings by the non-financial sector were up just 29%. Here, in its purest form, is rampant credit inflation, and inflation directed specifically at financial assets.

According to the flows of funds data of the Federal Reserve by sector, commercial banks and savings institutions were responsible for credit market borrowings of $126 billion in 1998. But what is it that causes these institution to borrow so heavily in the market? Their credit growth vastly exceeds their deposit growth. Government sponsored entities, largely Fannie Mae and Freddy Mac, had an increase in net borrowings of $304 billion; federally-related mortgage pools added $193 billion and "asset-backed issuers" a further $317 billion.

These numbers patently illustrate the extent to which the U.S. financial market has come to be dominated by credit creation outside the banking industry. It also makes it apparent that an incredible U.S. financial apparatus has created history's great financial alchemy, turning America's exploding mass of real estate loans into most desirable securities. This transformation was made possible by several related developments: Wall Street's creation of loan securitization, explicit and implied U.S. government guarantees, the development of a "repo" market providing ample financing for highly leveraged holdings of securities, and, importantly, the intermediation of mortgage lending by publicly traded companies (which enjoy the luxury of an implied government guarantee for their mountains of liabilities). With balance sheets leveraged 25 to 1 in mortgage securities, these financial companies have become the darling of investors and Wall Street investment bankers alike.

Indeed, the huge expansion of U.S. mortgage debt over the past years has been created largely outside the banking system, leaving expanding bank credit to finance other endeavors. In our view, this fantastic growth of non-bank credit is really the essence of the so-called American miracle. Banks accounted over the last three years for only about $200 billion of a total increase in outstanding household mortgage debt by $831 billion. During 1998, mortgage debt outstanding ballooned $492 billion, or just over one half of total non-financial debt growth. For comparison, during 1995 mortgage credit had expanded $208 billion, or just 30% of total non-financial credit expansion. In the fourth quarter of last year, by the way, the GSE's boosted their holding of assets by $138 billion, or at a 44% annualized rate.

DOW 10, 000

Earlier in this letter, we have described the incredible American credit excesses of the 1920s that stoked the economy and the stock market boom. We have long come to the conclusion that today's credit excesses are at least as bad, if not much worse. But drawing any comparisons between the two periods, we must further bear in mind that heavily leveraged speculation is today taking place in addition through the derivatives markets.

Before concluding this letter, another brief look at the stock market. Much has been written about the many divergences within the market. The most interesting, and we believe insightful, however, is gleaned from a more qualitative analysis.

We have looked at the types of companies that have fallen out of favor with Wall Street, and the stocks that the bulls now prefer. Those out of favor clearly include all manufacturing companies. As the global crisis deepens and broadens, Wall Street is understandably circumspect of most businesses that produce manufactured

goods. There is simply too much risk of disappointing earnings. As evidence, the Morgan Stanley Cyclical index has declined 9% over the past year.

Looking at the industries, groups and companies that are now favored by the bulls, it is apparent that Wall Street has gravitated to stocks where it sees low risk for earnings disappointments. No price seems too high to pay for a stock with little risk of missing earnings estimates. Wall Street now adores industries where management has considerable leeway as to reported earnings. This is particularly the case with financial companies, and we believe this largely explains Wall Street's astonishing affinity to this industry despite higher interest rates and a less-than-sanguine environment. Amazingly, the best year-to-date performing S&P group is Investment Banking & Brokerage with a 45% gain. Nor is any price seemingly too high to pay for an on-line brokerage, aggressive card lenders, or insurance companies, as long as they have next quarter's earnings in the bag.

Similarly, Wall Street absolutely loves anything that has to do with media, whether it is radio, television, Hollywood studios, cable, billboards, theme parks or automobile racetracks. Furthermore, Wall Street is completely infatuated with the communications revolution, truly a black hole for investment banking fees, as this industry proceeds pell-mell with an unprecedented communication infrastructure buildout. The NASDAQ Telecommunications Index has a year-to-date gain of more than 20% and a market cap of a stunning $285 billion.

With little if any current or expected profits, Wall Street can sleep soundly at night not fretting over potential warnings of earnings disappointments.

Nothing, however, compares to the Internet stocks. The current Internet craze certainly epitomizes Wall Street's attractions to companies without actual earnings or even earnings expectations, or with any other issues that could lead to any disappointment. Admittedly, these stock are perfect for the present environment, providing a speculators' paradise as The Street.com Internet Index has gained 55% so far in 1999 and 185% in the past 12 months. The 20 stocks within the group now trade with a market capitalization of $245 billion—and that with no earnings over the past year.

MORE BULLISH TALK THAN BULLISH ACTION

Considering the credit explosion in the United States, we keep wondering about its effects and its sustainability. In the view of the bulls, a virtuous perpetual motion is at work propelling the U.S. economy infinitely forward. The rising stock market generates the household wealth that fosters the borrowing that pays for the spending that creates the jobs and the soaring wage and salary incomes that generate the confidence that encourages people to invest in stocks that keep stock prices rising and rising. It appears, though, that stocks are not the collateral. It is generally the homes that are put up as collateral, as evidence in the explosion of residential mortgages. The inherent hope is that these debts can one day be repaid by selling stocks.

For reasonable people, it is clear that this can't last, yet they stay in the market because they hope to get out before the bubble bursts. Overall, however, we register a lot more bullish talk than bullish action. While the Dow has been setting new highs, the number of shares whose prices are still going up is dwindling fast. Two thirds of the shares in the Russel 2000 are now more than 20% below their 1998 highs. There is a growing gap between a small group of leading shares in the indexes and the large rest of stocks.

Essentially, this broad weakness in the U.S. stock market must reflect diminishing net inflows of new money. According to the Fed's flow of funds accounts that is, in fact, the case. The biggest single net buyer of equities are the corporations themselves. We mentioned already the latest figures for new securities buying: $262.8 billion in 1998 as a whole and $474 at an annual rate for the fourth quarter. Further substantial buying, though at incomparably smaller scale, came from life insurance, state and local government retirement funds

and foreigners. Equity buying by private households through mutual funds declined to $143 billion, but net direct selling on their part amounted to $500 billion. Measured by the indexes, it may still look like a bull market, but otherwise, there are considerably more bearish symptoms.

CONCLUSIONS:

The world economy is in its most precarious state in the whole postwar period, and it's worsening. A distinct barometer of spreading global economic weakness is the savage commodity price deflation. Given global economic growth of less than 2%, excess capacity continues to grow with cumulative downward pressure on world inflation.

It is crucial to realize that this world economic malaise is not of cyclical but of deeper-seated structural nature. At its bottom lie several years of national and international credit excesses which have caused airy credit structures and far-reaching dislocations of productive resources.

It is widely believed that the U.S. expansion can continue without recession because inflation is not a worry. This is wishful thinking, based on excessive faith in the powers of central banks in general, and of Mr. Greenspan in particular to "inflate" or "reflate" the economy, if they only play their cards right.

The signs of a developing global bear market in equities are everywhere. Worldwide, stock prices are well below their all-time highs. In the United States, the sharp rise in the major market indices in response to the Fed's easing masks appalling breadth and the fact that the great majority of stocks are considerably down from their peaks.

The credit explosion in the fourth quarter of 1998 postponed any slowdown of the U.S. economy. But with business and consumer spending heavily geared to the continuation of the stock market and the credit bubble, the economy is definitely living on borrowed time. Most importantly, what has to be expected is a hard landing, not just a cyclical slowdown.

With consumer spending running well ahead of income growth, the mere absence of further wealth effects, let alone a sustained pullback in stock prices, will essentially end the decline of the savings ratio and hence cause consumer spending to slow sharply. Always to keep in mind, the U.S. economy is not bursting with fundamental strength but with exorbitant credit excesses.

In that economic and financial environment, U.S. interest rates will sink to sharply lower levels. Long-term Treasury bonds should go into a bull market, but spreads of lower-grade credit over Treasuries will rise sharply. Fears of an impending rate hike by the Fed have hit bonds hard. Yet the risk of further rises in rates are very limited. For somebody with patience, this temporary condition offers a buying opportunity.

The growing perception that the Euroland economy is weakening while the U.S. economy continues to power ahead has led to a softening of the euro. A pop in the stock market will bring both U.S. economic growth and the dollar sharply down. Both are tightly correlated. The overriding potential danger down the road is that this mutually reinforcing process will work dramatically in reverse, towards recession and deflation.

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